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IN THE

Supreme Court of the United States

NO. 498

CENTRAL TRUST COMPANY OF NEW YORK,
Plaintiff,

v.

THE PITTSBURG, SHAWMUT AND NORTHERN RAILROAD COMPANY, SHAWMUT MINING COMPANY, THE KERSEY MINING COMPANY and HAMILTON TRUST COMPANY, Defendants.

ROBERT WOMSLEY, CHARLES A. WOODS, JR., and KENNETH BALLENTYNE, Constituting a Committee for the Protection of Holders of Certificates of Indebtedness of the Receiver of The Pittsburg, Shawmut and Northern Railroad Company and the Mortgaged Properties of the Shawmut Mining Company and The Kersey Mining Company; HUGO E. SELLGER; EDWARD L. BLACKMAN and PFLUGFELDER, BAMPTON & RUST, a Partnership, Individual Holders of Some of Such Certificates, Petitioners.

PETITION FOR REVIEW ON WRIT OF CERTIORARI OF A JUDGMENT OF THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT.

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PETITION FOR REVIEW ON WRIT OF CERTIORARI OF A JUDGMENT OF THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT.

To the Honorable Fred M. Vinson, Chief Justice of the United States and the Associate Justices of the Supreme Court of the United States:

ROBERT WOMSLEY, CHARLES A. WOODS, JR., and KENNETH BALLENTYNE, constituting a Committee for the Protection of Holders of Certificates of Indebtedness of the Receiver of The Pittsburg, Shawmut and Northern Railroad Company and the Mortgaged Properties of the

Shawmut Mining Company and The Kersey Mining Company; HUGO E. SELLGER; EDWARD L. BLACKMAN and PFLUGFELDER, BAMPTON & RUST, a Partnership, Individual Holders of some of such Certificates, Petitioners, respectfully petition for review on writ of certiorari of a judgment of the United States Court of Appeals for the Third Circuit entered September 29, 1949, on which rehearing was denied October 26, 1949, affirming an order of the District Court of the United States for the Western District of Pennsylvania, entered November 9, 1948.

SUMMARY STATEMENT OF THE MATTER INVOLVED.

(a) The Proceedings Below

The District Court did not file an opinion. The opinion of the Court of Appeals is officially reported at 176 F. 2d 937.

(b) The Facts of the Case

Review is sought of a judgment of the United States Court of Appeals for the Third Circuit affirming a final order of the District Court of the United States for the Western District of Pennsylvania, establishing priorities as between creditors of a receiver of a railroad whose claims consisted of (1) unpaid expenses of operation of the railroad incurred by the receiver during the course of the receivership and (2) the principal of and interest on certificates of indebtedness issued and sold by such receiver pursuant to orders of the receivership court to raise funds necessary to keep the railroad in operation.

The receivership commenced in 1905. Successive receivers operated the railroad until the Spring of 1947,

when the railroad was sold. Administrative costs, such as court costs, receivers' fees, fees of their attorneys, etc., and unpaid operating expenses incurred by the present receivers to which no exceptions were filed, have been paid in full out of the proceeds of such sale. The balance of such proceeds now constitutes the fund available for distribution. The allowed claims of the remaining creditors of the receiver, described in the preceding paragraph, exceed the amount of such fund. Holders of mortgage bonds of the railroad and its equity securities will receive nothing since the estate is insolvent as to the receiver's creditors alone.

By a series of orders entered during the course of the receivership, the District Court authorized the receiver to issue and sell certificates of indebtedness, hereinafter referred to as the "certificates", until at August 1, 1910, there had been issued and were outstanding certificates in the aggregate face amount of $3,100,000.00. Substantially all of the proceeds of such certificates were, pursuant to orders of the District Court, expended by the receiver for capital improvements, equipment, rehabilitation of the railroad and similar capital items without which, as the Appellate Division of the Supreme Court of New York in *Weaver v. Pacific Improvement Company,* 198 App. Div. 825, 191 N. Y. Supp. 3, said "the road could not have been kept running."

Thereafter, by a series of refunding and reissue orders, the aggregate face amount of the issued and outstanding certificates was reduced until a final order, entered June 16, 1927, brought the amount of the outstanding certificates down to its present size of $2,044,350. Of these, $112,290 in principal amount are

held as a part of the receivership estate, and the balance of $1,932,060 in principal face amount is publicly held.

The orders authorizing the various issues, refundings, and reissues of the certificates and the orders authorizing operation of the railroad and mines contained no express provisions with respect to relative priorities in case of liquidation as between claims based on ownership of the receiver's certificates and claims for payment of operating expenses incurred by the receivers.

The typical form of the orders in which the successive receivers were authorized to incur and pay expenses of operation was as follows:

> "ORDERED, that out of the funds from time to time coming into his hands *from the operation of the said railroad,* the said receiver shall pay the necessary current expenses of operating the mortgaged property and premises, and executing the trust hereby vested in him, including all taxes and assessments upon the said property." (Emphasis supplied)

The typical language used in the orders authorizing the issue, refund and reissue of certificates is in relevant part as follows:

> "* * * said certificates and each of them shall be a debt by said Receiver for the benefit, protection and preservation of the mortgaged properties of the said defendants and of the creditors and holders of the stock and bonds of said defendant Railroad Company and shall be a lien upon said mortgaged properties, railroads and franchises, coal lands, mining rights and mining plants, and the net income, receipts and profits thereof, prior to the lien of said

mortgages or deeds of trust, or any of them, theretofore created under said properties, and shall be recognized as such in any reorganization of said defendants; and in case of any sale of said mortgaged properties by judicial procedure or otherwise, said certificates, principal and interest, and each of them, shall be paid from the moneys arising from such sale prior to any payment on account of said mortgages or deeds of trust, or any of them, unless sooner paid and cancelled by said Receiver, and said certificates, and each of them, shall be and remain a lien upon said mortgaged properties prior to the lien of said mortgages or deeds of trust or any of them, until the amount thereof, principal and interest, shall be fully paid; * * *"

By the terms of the orders of the District Court authorizing their issuance, the certificates now outstanding bore interest at the rate of 6% per annum, payable June 1 and December 1, and became due and payable June 1, 1929. Such certificates were not paid at maturity although interest thereon was paid until 1932. No interest has been paid on them since December 1, 1932.

On November 29, 1945, the District Court entered its order removing the then receiver, John D. Dickson, as receiver, and appointing successor receivers. In conducting the operation of the railroad Dickson had incurred, as receiver, various debts for operating expenses, such as for merchandise, supplies, freight, car service and other railroad charges which had not been paid at the time of his removal as receiver and were not paid by his successors. Such unpaid operating expense claims aggregate $269,541.22, all of which have been

allowed. Claims were filed by public holders of certificates having a principal face amount of $1,832,020. Such claims included claims for unpaid interest which had been accrued on such certificates since December 1, 1932, in the annual amount of $109,921.20. Holders of certificates having an aggregate principal amount of $100,040 failed to file claims thereon. The receivers now in office have filed claims on behalf of such unknown holders. No claim has been or will be filed with respect to certificates in the principal amount of $112,290 which form a part of the receivership estate. All of the claims filed with respect to the certificates were allowed as to the principal of such certificates but not as to the interest.

On March 24, 1948, the District Court ordered the allowance of certain claims not here in controversy, as to which exceptions had been filed, and on April 29, 1948, directed the receivers to prepare and file a Schedule of Distribution which should provide (a) for the payment in full, but without interest, of all claims of operating expense creditors of receiver Dickson, (b) for payment of a first dividend of 25% on the principal face amount of the certificates and (c) for the suspension of payment on certain claims. A Schedule of Distribution prepared in accordance with such order was forthwith filed and on May 7, 1948, the District Court entered an order confirming *nisi* such schedule, to become final without further order unless exceptions should be filed thereto.

Within the time allowed therefor exceptions were filed to the Schedule of Distribution and to the orders of April 29 and May 7, 1948, asserting that the District Court had erred in providing for payment in full of the claims of operating expense creditors in priority to the

claims of the certificate holders; in failing to provide for division of the distributable fund pro rata among the certificate holders and the operating expense creditors including, in the case of the certificate holders, the amount of their claims for interest; in failing to allow the claims for accrued and unpaid interest on the certificates and in failing to treat the interest on the certificates in the same manner as the operating expense claims.

On November 9, 1948, the District Court dismissed such exceptions, affirmed Schedule A of the Schedule of Distribution, which related to payment of expense claims incurred in operation of the railroad in priority to the claims of the certificate holders, and directed that distribution be made in accordance with such Schedule A.

The effect of the District Court's orders authorizing payment in full of the allowed claims of such operating expense creditors was to create a preference for such claims permitting their payment in full and leaving available for distribution to the holders of certificates the balance of the fund which, however, is much less than the principal face amount of the certificates with respect to which claims had been filed and allowed.

As a result of such orders the operating expense creditors will receive 100 cents for each dollar of the face amount of their respective claims, whereas, the certificate holders will be paid with respect to each dollar of the principal of the certificates not more than 45.431 cents or with respect to the aggregate of the principal amount of and unpaid interest on the certificates not more than 24.425 cents per dollar. If the priority is denied and pro rata distribution ordered the percentage

of recovery by both operating expense creditors and the certificate holders will be substantially less than one hundred per centum but will be uniform.

JURISDICTION.

The jurisdiction of this Court is invoked under Title 28, United States Code, Section 1254, 62 Stat. 928, on the ground that the decision below was a judgment of the United States Court of Appeals for the Third Circuit in a civil case on appeal from a final decision of the District Court of the United States for the Western District of Pennsylvania. Petitioners are parties to such civil case, the petitioning committee having been permitted by order of such District Court to intervene generally in the proceeding and the individual petitioners being creditors of the receiver whose claims were filed and allowed as to the principal thereof but not as to the interest.

The judgment of the Court of Appeals affirming the order of the District Court was entered September 29, 1949, rehearing was denied October 26, 1949, and this petition was filed November 30, 1949.

THE QUESTIONS PRESENTED.

In this Federal railroad receivership the receiver's allowed debts alone exceed the fund, resulting from liquidation of the receivership estate, which is available for distribution. All administrative costs, such as, court costs, fees of the receiver, their counsel, etc., and the operating expenses incurred by the receivers now in office have been paid in full, no objections thereto having been filed. Subsequent administrative costs have not as yet been claimed but will not be contested as to their priority. The remaining debts of the receiver consist of (1) claims for unpaid operating expenses of the railroad and mines incurred by a former receiver and (2) claims for the principal of and interest on receiver's certificates issued and sold to the public by the former receiver under orders of the receivership court to procure funds necessary to continue the operation of the railroad. The District Court, after allowance of the principal of both classes of claims but disallowance of accrued interest on the receiver's certificates, ordered that the claims for unpaid operating expenses incurred by the former receiver should be first paid in full out of the fund available for distribution, thus granting to such operating expense claimants full priority over the holders of the receiver's certificates. Neither the orders authorizing operation of the railroad and the incurring of expenses in so doing nor the orders authorizing issue, sale and re-issue of the receiver's certificates contained any provision establishing relative priorities upon liquidation as between receiver's debts for operating expenses and those evidenced by receiver's certificates. Under these circumstances:

1. Did not the order granting such priority retrospectively discriminate grossly as between creditors of the receiver of equal rank?

2. Was not such order a serious violation of the established public policy that courts shall not repudiate their self-incurred obligations?

3. Did not such order directly violate the established rule of this Court that where the fund available for distribution is less than the allowed claims of equal rank against the receiver, all such claims shall share pro rata in the fund?

4. Insofar as such order approved disallowance of the interest accrued on the receiver's certificates, did not such order constitute a gross violation of the court's duty to honor its own obligations?

REASONS RELIED ON FOR ALLOWANCE OF THE WRIT.

1. The decision of the Court below is in conflict with the decision of this Court in *Union Trust Company of New York v. Illinois Midland Railway Company,* 117 U.S. 434, 6 S. Ct. 809 (1886), which holds (a) that where a receiver's debts having priority over mortgage bonds of any railroad, may exceed the fund available for distribution, there shall be no priority or preference among such debts, but all shall stand alike; and (b) that where receiver's certificates are issued for debts contracted by the court, having jurisdiction over the parties and the subject matter, to persons who in good faith invest their money, for the benefit of the property in the possession of the court, the certificates should be paid according to their tenor?

2. The decision of the court below is in conflict with the decisions of the Circuit Court of Appeals for the Fifth Circuit in *First National Bank of Houston v. Ewing,* 103 F. 168 (1900), and of the Circuit Court of Appeals for the Eighth Circuit in *Reconstruction Finance Company v. Missouri-Kansas-Texas Railroad Company,* 122 F. 2d 326 (1941), which hold that, in the absence of special equities justifying different treatment, receiver's debts for operating expenses and on receiver's certificates are entitled to share pro rata in the fund available for distribution where such fund is insufficient to pay all of the receiver's debts in full.

3. The decision of the court below sanctions a gross abuse of judicial power by the District Court in its repudiation of self-incurred obligations which it authorized to be issued and sold to the public, backed by

the District Court's most solemn judicial assurance as to their priority over existing mortgages and without provision in any then existing orders as to relative priorities among the receiver's debts in case, upon liquidation, the fund available for distribution should prove to be insufficient to pay in full all of the receiver's debts. Such departure from the accepted and usual course of judicial proceedings calls strongly for an exercise of this Court's power of supervision.

Respectfully submitted,

ROBERT WOMSLEY, CHARLES A. WOODS, JR., and KENNETH BALLENTYNE, Constituting a Committee for the Protection of Holders of Certificates of Indebtedness of the Receiver of The Pittsburg, Shawmut and Northern Railroad Company and the Mortgaged Properties of the Shawmut Mining Company and The Kersey Mining Company; HUGO E. SELLGER; EDWARD L. BLACKMAN and PFLUGFELDER, BAMPTON & RUST, a Partnership, Individual Holders of Some of Such Certificates,

Petitioners.

By EARL F. REED,
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BRIEF IN SUPPORT OF PETITION FOR REVIEW ON WRIT OF CERTIORARI OF A JUDGMENT OF THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT.

OPINIONS BELOW.

The District Court did not file an opinion. The opinion of the Court of Appeals is officially reported at 176 F. 2d 937.

JURISDICTION.

The jurisdiction of this Court is invoked under Title 28, United States Code, Section 1254, 62 Stat. 928, on the ground that the decision below was a judgment of the United States Court of Appeals for the Third Circuit in a civil case (a railroad equity receivership) on appeal from a final decision of the District Court of the United States for the Western District of Pennsylvania therein. Petitioners are parties to such civil case, the petitioning committee having been permitted by order of such District Court to intervene generally in the proceeding and the individual petitioners being creditors of the receiver whose claims were filed and allowed as to the principal thereof but not as to the interest.

The judgment of the Court of Appeals affirming the order of the District Court was entered September 29, 1949, rehearing was denied October 26, 1949, and this petition was filed November 30, 1949.

STATEMENT OF THE CASE.

Review is sought of a judgment of the United States Court of Appeals for the Third Circuit affirming a final order of the District Court of the United States for the Western District of Pennsylvania (R. 89a, 90a), establishing priorities as between creditors of a receiver of a railroad in a Federal equity receivership whose claims consisted of (1) unpaid expenses of operation of the railroad incurred by the receiver during the course of the receivership and (2) the principal of and interest on certificates of indebtedness issued and sold by such receiver pursuant to orders of the receivership court to raise funds necessary to keep the railroad in operation.

The receivership commenced in 1905. (R. 1a, 13b-17b) Successive receivers operated the railroad until the Spring of 1947, when the railroad was sold. Administrative costs, such as court costs, receivers' fees, fees of their attorneys, etc., and unpaid operating expenses incurred by the present receivers to which no exceptions were filed, have been paid in full out of the proceeds of such sale (R. 21b). The balance of such proceeds now constitutes the fund available for distribution. (R. 64a) The allowed claims of the remaining creditors of the receiver described in the preceding paragraph exceed the amount of such fund. (R. 64a, 65a) Holders of mortgage bonds of the railroad and its equity securities will receive nothing since the estate is insolvent as to the receivers' creditors alone.

By a series of orders entered during the course of the receivership, the District Court authorized the receiver to issue and sell certificates of indebtedness,

hereinafter referred to as the "certificates", until at August 1, 1910, there had been issued and were outstanding certificates in the aggregate face amount of $3,100,000.00 (R. 1a, 2a). Substantially all of the proceeds of such certificates were, pursuant to orders of the District Court, expended by the receiver for capital improvements, equipment, rehabilitation of the railroad and similar capital items (R. 6b) without which, as the Appellate Division of the Supreme Court of New York in *Weaver v. Pacific Improvement Company,* 198 App. Div. 825, 191 N. Y. Supp. 3, said "the road could not have been kept running".

Thereafter, by a series of refunding and reissue orders, the aggregate face amount of the issued and outstanding certificates was reduced until a final order entered June 16, 1927, brought the amount of the outstanding certificates down to its present size of $2,044,350. (R. 3a, 65a) Of these, $112,290 in principal amount are held as a part of the receivership estate (R. 65a), and the balance of $1,932,060 in principal face amount is publicly held. (id.)

The orders authorizing the various issues, refundings, and reissue of the certificates and the orders authorizing operation of the railroad and mines contained no express provisions with respect to relative priorities in case of liquidation as between claims based on ownership of the receivers' certificates and claims for payment of operating expenses incurred by the receivers.

The typical form of the orders in which the successive receivers were authorized to incur and pay expenses of operation was as follows:

"ORDERED, that out of the funds from time to time coming into his hands *from the operation of the said railroad,* the said receiver shall pay the necessary current expenses of operating the mortgaged property and premises, and executing the trust hereby vested in him, including all taxes and assessments upon the said property." (Emphasis supplied) (R. 16b)

The typical language used in the orders authorizing the issue, refund and reissue of certificates is in relevant part as follows:

"* * * said certificates and each of them shall be a debt by said Receiver for the benefit, protection and preservation of the mortgaged properties of the said defendants and of the creditors and holders of the stock and bonds of said defendant Railroad Company and shall be a lien upon said mortgaged properties, railroads and franchises, coal lands, mining rights and mining plants, and the net income, receipts and profits thereof, prior to the lien of said mortgages or deeds of trust, or any of them, theretofore created under said properties, and shall be recognized as such in any reorganization of said defendants; and in case of any sale of said mortgaged properties, by judicial procedure or otherwise, said certificates, principal and interest, and each of them, shall be paid from the moneys arising from such sale prior to any payment on account of said mortgages or deeds of trust, or any of them, unless sooner paid and cancelled by said Receiver, and said certificates, and each of them, shall be and remain a lien upon said mortgaged properties prior to the lien of said mortgages or deeds of trust or

any of them, until the amount thereof, principal and interest, shall be fully paid; * * *" (R. 17a, 24a, 26a, 27a)

By the terms of the orders of the District Court authorizing their issuance, the certificates now outstanding bore interest at the rate of 6% per annum, payable June 1 and December 1, and became due and payable June 1, 1929. (R. 45a-48a) Such certificates were not paid at maturity although interest thereon was paid until 1932. No interest has been paid on them since December 1, 1932.

On November 29, 1945, the District Court entered its order removing the then receiver, John D. Dickson, as receiver, and appointing successor receivers. (R. 3a) In conducting the operation of the railroad, Dickson had incurred, as receiver, various debts for operating expenses, such as for merchandise, supplies, freight, car service and other railroad charges which had not been paid at the time of his removal as receiver and were not paid by his successors. (R. 64a-74a) Such unpaid operating expense claims aggregate $269,541.22, all of which have been allowed. (R. 66a-71a) Claims were filed by public holders of certificates having a principal face amount of $1,832,020. (R. 65a) Such claims included claims for unpaid interest which had been accrued on such certificates since December 1, 1932, in the annual amount of $109,921.20. Holders of certificates having an aggregate principal amount of $100,040 failed to file claims thereon. (R. 79a) The receivers now in office have filed claims on behalf of such unknown holders. (id.) No claim has been or will be filed with respect to certificates in the principal amount of $112,290 which form a part of the receivership estate. All of the claims

filed with respect to the certificates were allowed as to the principal of such certificates but not as to the interest. (R. 75a-79a)

On March 24, 1948, the District Court ordered the allowance of certain claims not here in controversy, as to which exceptions had been filed (R. 62a), and on April 29, 1948, directed the receivers to prepare and file a Schedule of Distribution which should provide (a) for the payment in full, but without interest, of all claims of operating expense creditors of receiver Dickson, (b) for payment of a first dividend of 25% on the principal face amount of the certificates and (c) for the suspension of payment on certain claims. A Schedule of Distribution prepared in accordance with such order was forthwith filed and on May 7, 1948, the District Court entered an order confirming *nisi* such schedule, to become final without further order unless exceptions should be filed thereto. (R. 80a)

Within the time allowed therefor exceptions were filed to the Schedule of Distribution and to the orders of April 29 and May 7, 1948, asserting that the District Court had erred in providing for payment in full of the claims of operating expense creditors in priority to the claims of the certificate holders; in failing to provide for division of the distributable fund pro rata among the certificate holders and the operating expense creditors including, in the case of the certificate holders, the amount of their claims for interest; in failing to allow the claims for accrued and unpaid interest on the certificates and in failing to treat the interest on the certificates in the same manner as the operating expense claims. (R. 81a-88a)

On November 9, 1948, the District Court dismissed such exceptions, affirmed Schedule A of the Schedule of Distribution, which related to payment of expense claims incurred in operation of the railroad in priority to the claims of the certificate holders, and directed that distribution be made in accordance with Schedule A. (R. 89a-90a)

The effect of the District Court's orders authorizing payment in full of the allowed claims of such operating expense creditors was to create a preference for such claims permitting their payment in full and leaving available for distribution to the holders of certificates the balance of the fund which, however, is much less than the principal face amount of the certificates with respect to which claims had been filed and allowed. (R. 64a-65a)

As a result of such orders the operating expense creditors will receive 100 cents for each dollar of the face amount of their respective claims, whereas, the certificate holders will be paid with respect to each dollar of the principal of the certificates not more than 45.431 cents or with respect to the aggregate of the principal amount of and unpaid interest on the certificates not more than 24.425 cents per dollar. If the priority is denied and pro rata distribution ordered the percentage of recovery by both operating expense creditors and the certificate holders will be substantially less than one hundred per centum but will be uniform.

SPECIFICATION OF ERRORS.

The Court of Appeals erred:

1. In holding that the receiver's debts for operating expenses incurred in the operation of the receivership properties were entitled to be paid in full with priority over the receiver's debts which were evidenced by receiver's certificates of indebtedness issued to procure funds found to be necessary to the continued operation of the railroad.

2. In failing to hold that all allowed debts of the receiver, including in the case of receiver's certificates of indebtedness the accrued and unpaid interest thereon, should share pro rata in the fund available for distribution.

3. In failing to allow as a debt of the receiver, entitled to share pro rata with all other debts of the receiver in the fund available for distribution, the unpaid interest accrued since December 1, 1932, on the receiver's certificates, the debts evidenced by such certificates having been allowed as to the principal thereof only.

4. In sanctioning the repudiation by the District Court of the formal written obligations of its receiver which were sold to the public under the District Court's representation of their high priority as to both the principal and interest thereof without disclosure that the District Court might subsequently, in case of inability to pay all of the receiver's debts in full, subordinate such written obligations to other debts of the receiver having no higher rank or equity.

SUMMARY OF ARGUMENT.

The fund available for distribution consists solely of the proceeds of sale of the corpus of the receivership estate. Administrative costs and expenses have been paid therefrom without objection on the part of petitioners. *Qua* such fund the claims on the receiver's certificates and for the receiver's unpaid operating debts were of equal rank.

The lien of the operating debts had first priority on gross income from operations, while the certificates were expressly made a lien, prior to existing mortgages on the corpus and the net income. No provision was made in any order with respect to relative priorities as between the receiver's debts in case the estate should become insolvent as to the receiver's debts alone, presumably because such possibility was not foreseen. While the orders authorizing the incurring of operating debts necessarily implied that the lien of such debts would also take priority over existing *mortgage liens* if the operating income were insufficient to pay the operating debts in full, it was not implied that such operating debts should take priority over the express lien of the receiver's certificates upon the corpus even if the estate became insolvent as to the receiver's debts alone. In such case, all debts of the receiver, except for taxes, should share pro rata under the doctrine of *Union Trust Company of New York v. Illinois Midland Railway Company,* 117 U. S. 434, 6 S. Ct. 809 (1886). While equitable considerations in rare instances may justify deviation from such doctrine, the court below found none.

Therefore, the orders disallowing the accrued interest on the certificates and authorizing payment in full of the operating expenses with priority over the certificates were grossly inequitable, were clearly contrary to the announced rule of this Court, and constituted a flat repudiation of the District Court's self-incurred debts, an exercise of judicial power "not to be sanctioned under any conditions": *Bank of Commerce v. Central Coal & Coke Company,* 115 F. 878 (CCA 8, 1902).

ARGUMENT.

Much of the long history of this receivership is recited in detail in the opinions of the Court of Appeals of New York and the Appellate Division of the Supreme Court of New York in *Central Trust Company of New York v. Pittsburg, Shawmut and Northern Railroad Company,* 174 App. Div. 800, 161 N. Y. Supp. 694; affirmed 220 N. Y. 690, 116 N. E. 1040; 179 App. Div. 60, 168 N. Y. Supp. 702; reversed 223 N. Y. 347, 119 N. E. 565; 189 App. Div. 921, 178 N. Y. Supp. 882; appeal dismissed 229 N. Y. 68, 128 N. E. 114; *Smith v. Pacific Improvement Company,* 104 N. Y. Misc. 481, 172 N. Y. Supp. 65, and *Weaver v. Pacific Improvement Company et al.,* 198 App. Div. 825, 191 N. Y. Supp. 3, 541, affirmed 234 N. Y. 418, 138 N. E. 42. Examination of such opinions by this Court should be of substantial value in appraising the problem presented in the case at bar.

The receiver was authorized to operate the railroad in the public interest and to pay the expenses of such operation out of the income resulting therefrom. The effect of orders of such kind is well established. The

expenses so incurred are entitled to payment out of such income in priority to the holders of existing mortgages who might otherwise be entitled to such income and, in case of a deficiency in such income, to displace existing mortgage liens: *Finletter, Law of Bankruptcy Reorganizations* (1939 Ed.), pp. 207 *et seq.; Glenn on Liquidation,* Section 572; *Fosdick v. Schall,* 99 U. S. 235, 25 L. Ed. 39.

The receiver was also from time to time during the course of the receivership expressly authorized to borrow money on receiver's certificates of indebtedness for capital expenditures found to be necessary for the continued operation of the railroad. Such certificates were, as is permissible in the case of railroad receiverships, given an express first lien on the net income from operations and on the corpus of the estate itself, with priority over the existing mortgage liens: *id.*

The receivership court in the case at bar did not in any of the orders authorizing operation of the line or authorizing issuance and sale of receiver's certificates of indebtedness deal with the question of relative priorities in case the income from operations should not meet the expenses of such operation and the proceeds of liquidation of the corpus of the estate should not be sufficient to satisfy all receiver's debts having priority over the mortgages, presumably because this unhappy circumstance was not foreseen.

The courts below when faced, at the conclusion of the receivership, with the fact that there was a deficiency in income and that the fund available for distribution, which had resulted solely from sale of the corpus of the estate, was less than the aggregate of the receiver's

debts, had the problem of determining, in the absence of any prior order dealing with the subject, whether there should be any relative priorities as between the receiver's operating debts and the receiver's debts represented by the certificates, the former having an implied lien on the corpus prior to the mortgages and the latter an express lien on the corpus prior to the mortgages. The obviously proper distribution of the proceeds of sale of the corpus under such circumstances would have been a pro rata division on the basis of the total amount of all of the receiver's debts. This would have been the normal result of application of the equitable maxim that "equality is equity" and in accord with the established doctrine in such circumstances laid down by this Court in *Union Trust Company of New York v. Illinois Midland Railway Company,* 117 U. S. 434, 6 S. Ct. 809.

The courts below, however, disregarded not only these guide posts for decision but also the express lien of the certificates on the corpus in holding that there should not be pro rata distribution but that the operating debts should first be paid in full out of the fund, thus displacing the express lien of the certificates on the corpus.

Precisely the same question as in the case at bar was before this Court in the *Illinois Midland* case, *supra.* In that case the railroad system was not complete at the inception of the receivership. Several portions of the lines which were already subject to existing mortgages were unfinished and to be usable had to be completed and equipped. This was authorized by the receivership court which, in order to obtain the necessary funds, caused several series of receiver's certificates to

be issued and sold, each separate series being declared to be a lien upon the particular portion of the road to be completed with the proceeds of such series with priority over the existing mortgages on such portion. After completion of the consolidated system and operation for several years, the court ordered liquidation and distribution of the proceeds. The decree expressly reserved for future determination by the court all questions which might arise in the event that any of the roads forming the consolidated system should fail to produce on sale an amount in excess of the liens of the receiver's debts having priority over existing mortgages on such road.

Various appeals were taken in one of which the certificate holders assigned the above-described reservation as error and claimed that their certificates should be granted priority over all other debts incurred by the receiver in the operation of the system.

This Court sustained such appeal in part, holding that if there should be a deficiency all of the receiver's debts, except those for taxes as to which priority would be allowed, should share pro rata in the fund regardless of the terms of any previous orders. With respect to this, this Court said (6 S. Ct., pp. 834-5):

> "* * * By each of the orders of June 29, 1881, each certificate to be issued under it was declared to be a special charge and lien on the line and property in respect of which it should be issued, superior in lien to all mortgage bonds, and debts of the company, and receiver's debts, except such receiver's debts as had theretofore been declared by order of court to be special charges and liens on such line and property. We are of opinion that (with the

exception of debts for taxes, and receiver's certificates issued to borrow money to pay taxes or to discharge tax liens) there should be no priority or preference among the debts and claims, whether receiver's certificates or other debts, which are allowed precedence over the mortgage bonds of any road, but that all should stand alike, notwithstanding any orders heretofore made, and that the decree should so provide.

"It results that the decrees are reversed * * * so far as they fail to provide that there shall be no priority or preference (with the exception above stated) among the debts and claims, whether receiver's certificates or other debts, which are allowed precedence over the mortgage bonds of any road; and the causes are remanded to the circuit court, with a direction to make those modifications in the decrees; and in all other respects the decrees are affirmed. * * *"

The rule, therefore, in all cases where the receivership court is unable to pay all of its receiver's debts in full is this: When it is established that the receiver's debts cannot be paid in full out of the fund available for distribution the receivership court, in the absence of special equitable considerations, may not establish relative priorities among such debts, except debts for taxes, but must apply the equitable maxim that "equality is equity" and direct payment of all such debts, except debts for taxes, pro rata out of the fund available for distribution.

For an example of a case where equitable circumstances were held to justify modification of this prin-

ciple, see *Reconstruction Finance Corporation v. Missouri, Kansas, Texas Railroad Company,* 122 F. 2d 326 (CCA 8, 1941). In such case the claim of an employee of the receiver for damages for loss of both of his legs sustained in an accident in the course of his employment was given priority over other operating expenses and receiver's certificates because otherwise such employee would not have been paid in full for his injuries. The operating expenses and receiver's certificates with the exception of a small number of the latter, were held to be entitled to share pro rata in the fund for distribution which was substantially less than the total of the receiver's debts. Certain of the certificates, which were purchased on original issue with knowledge that the proceeds would be applied to satisfy six-months' claims, were subordinated to the other certificates and operating expenses on the theory that the receivership court was entitled to differentiate between classes of six-months' claims since it had complete discretion as to whether it would give preference to any six-months' claims and hence, since the proceeds of some of the certificates were with the acquiescence of the purchaser applied to a purpose for which no preference was allowed, such certificates should be given no higher status than the debts which their proceeds satified. It should be noted, however, that with the described exceptions the receiver's debts, whether for operating expenses or on certificates, shared pro rata in the fund.

Anderson v. Condict, 93 F. 349 (CCA 7, 1889), is not at variance with the *Illinois Midland* rule, *supra.* In such case the order authorizing the receiver's certificates expressly provided that the lien of such certificates was subordinate to the other expenses of the receiver. Hence, the purchasers of the certificates took them with

notice of the expense priority and could not complain when their security was diminished as a result of such priority. It may well have appeared to the court that it would have been unable to obtain operating credit if the order authorizing operations had not given priority to the operating expenses.

The *Illinois Midland* doctrine was expressly followed in *First National Bank of Houston v. Ewing*, 103 F. 168 (CCA 5, 1900). In that case the proceeds of liquidation were insufficient to pay all of the receiver's debts. A holder of operating expense claims (wages for labor performed) asserted that his claims should have priority over other operating expense claims and claims on receiver's certificates. Such contention was denied and it was held that all receiver's debts having priority over the mortgages should share alike in the fund.

In *Ball v. Improved Property Holding Co.*, 247 F. 645 (CCA 2, 1917), the facts were quite similar to the case at bar. The dispute as to the division of the fund for distribution was between the holders of receiver's certificates and the lessors of the leased premises which were the subject matter of the receivership, the lessors claiming rentals accrued on the premises during the receivership. The previous orders established no relative priorities as between these claims. Judge Learned Hand held that the claims should share pro rata, saying (247 F. 650-1):

> "[2] As in all such cases, the order authorizing the debt is the most conclusive evidence of the rank which the creditors should hold among other claims on the fund. This has been repeatedly used as the test in cases of receivers' certificates. An-

derson v. Condict, 93 Fed. 349, 35 C.C.A. 335; In re John W. Farley Co., 227 Fed. 378, 142 C.C.A. 74; St. Louis Union Trust Co. v. Texas So. Ry. Co., 59 Tex. Civ. App. 157, 126 S. W. 297; Lewis v. Linden Steel Co., 183 Pa. 248, 38 Atl. 606; In re J. B. & J. M. Cornell (D.C.) 201 Fed. 381. The court having the fund in its custody may establish such priorities as it sees fit, at least as against such creditors, as take the credit of the receiver after the order authorizing the earlier debt had once been passed. Every one who deals with a receiver knows that he has the power to charge his estate only as the court may authorize him, and, if a prospective creditor fails to inquire how far the assets may be already incumbered, he takes the risk.

"[3] We do not forget that the court is not absolutely bound to recognize the priorities fixed by the order, and that the matter is open to equitable readjustment, however conclusive a protection it may be to the receiver as to payments made under its terms. Louisville Ry. Co. v. Wilson, 138 U. S. 501, 506, 11 Sup. Ct. 405, 34 L. Ed. 1023. But, as we shall show, the orders in this case established no priorities as between the classes, and we are therefore relieved of the necessity of determining in what circumstances we should disregard them. All we need assert is that, disregarding the orders, there is no inherent ground for priority between him who lends money to pay accrued rent which is secured and him who allows the use of his property upon the agreement that the accruing rent shall be paid. Just why it should be taken against the lessor that he thought it profitable to leave the property at the

existing rent, or against the bondholders that they should have thought it profitable to assume the lease, does not appear obvious to us. We therefore proceed to consider the effect of the orders.

"[4, 5] The order of November 27, 1912, did not profess to give the certificates any priority except as against the mortgagees and the unsecured creditors. We pass the question whether those words were necessary in any event to give that priority if the order was granted after the mortgagees had become parties to the suit by asking to foreclose. Whether necessary or not, they meant to go no further in establishing priority than to put the certificates ahead of creditors, secured and unsecured, of the corporation. As between themselves and other creditors of the receiver the certificate holders stood, so far as we can see, on a parity for the reasons given above. Hence it follows that the rule should apply of Lewis v. Linden Steel Co., 183 Pa. 248, 38 Atl. 606, and In re J. B. & J. M. Cornell (D. C.) 201 Fed. 381, that the creditors of a receiver in the absence of some original marshaling to the contrary, or of some fundamental equity, shall share ratably. Therefore the fund should be brought in hotchpot with all claims of the receiver, and each should share pro rata. * * *"

In its opinion the Court of Appeals below referred to the fact that some 35% of the original certificates of indebtedness were retired out of net income and that some $1,000,000 of net income was devoted to improving the physical properties of the railroad. It may be that by such reference the Court of Appeals intended to call attention to special equities justifying payment of

the receiver's operating expenses in priority to the receiver's certificates. We submit that such use of income did not create any special equity of a kind which would justify a receivership court in repudiating its formal obligations.

The lien of the certificates expressly extended to the net income and, when such net income existed, it was with the formal approval of the receivership court applied to payment in part of the certificates and to necessary improvement of the properties from which the operating income was derived. Such dedication completely eliminated such net income from the subsequent scope of operation of the prior right to the income from operations afforded to operating expense creditors. The natural tendency of such dedication of net income was to maintain or increase subsequent operating income.

Furthermore, such use of net income is of no concern to the operating expense creditors here claiming priority. The claims of the present operating expense creditors arose during the administration of John D. Dickson as receiver, whose term of administration extended from December, 1923 to November, 1945. The dedication of net income to retirement of certificates and making of capital improvements took place prior to July 3, 1917 (R. 6b). Obviously any extensions of credit made after 1917, as they were by the operating expense creditors at bar, were made with notice of the orders appropriating such income to such described purposes and that such net income would not thereafter be available to defray operating expenses. The creditors in the case at bar can only have extended credit at a time

when they either knew or were bound to know that their sole security was the subsequently accruing income of the receivership estate plus the implicit right to share equally with other creditors of the receiver if, upon liquidation, the receivership estate should prove insufficient to pay all receiver's debts in full.

We submit that the courts below found no special equity existed which justified their repudiation of the self-incurred debts of the receivership court and in fact no special equity could have been found because none existed.

The court below appears to have confused diversion of income to the benefit of mortgagees, which is at the bottom of the rule permitting displacement of mortgage liens by the receiver's operating expense creditors in cases of such diversion, with use of net income by the court itself to pay its own debts and to enable continued operation of the railroad. These cases are completely unlike and not comparable in any respect.

The refusal of the courts below to direct payment of the certificates according to their tenor cannot be too severely criticized. The certificates were sold to the public backed by the most formal representations of the receivership court itself as to the high priority of their lien for both principal and interest.

When unable to pay their own debts in full receivership courts have the power to modify existing priorities but may do so only within the strict confines of equitable principles. We submit that in the case at bar the modification ordered was a gross abuse of such judicial power

and went far beyond the limits within which modification could equitably be made since it fully displaced the express lien of the certificates for the benefit of debts due creditors of the receiver whose claims had no express lien on the corpus of the estate. We do not contend that the receiver's operating debts should have been subordinated to the receiver's debts on the certificates but we do assert that all of the receiver's debts, including the receiver's debt for unpaid interest on the certificates, should have been held entitled to share pro rata in the fund.

Disallowance of the accrued and unpaid interest on the certificates was an abuse of judicial power of the worst sort and should never be countenanced. In the *Illinois Midland Railway Company* case, *supra,* this Court, with respect to the contention that interest on receiver's certificates should not be allowed, said (6 S. Ct. at p. 824):

> "It was also contended before the commissioner that all that the holders of these certificates were equitably entitled to was the money they paid, and without interest, and not the face of the certificates and interest. The view taken by the Commissioner, and confirmed by the circuit court, was that, as the certificates were issued for debts contracted by the court, when it had jurisdiction of the parties and of the subject-matter, to persons who in good faith invested their money, for the benefit of the property in the possession of the court, the certificates should be paid according to their tenor, as authorized. * * *"

In *Bank of Commerce v. Central Coal & Coke Company*, 115 F. 878 (1902), the Circuit Court of Appeals for the Eighth Circuit pointedly observed (115 F. at p. 880):

"* * * The obligations of the railroad company to pay its debts is not affected by the receivership and foreclosure. It retains its corporate existence, and its creditors may still pursue it, and in some cases its officers and stockholders. But it is not so with the debts contracted by the court. They are not debts of the railroad company, and the company is not liable for them. The court alone is liable for its debts. That obligation imposes on the court the duty to apply the property or its proceeds in its custody and control to the payment of the debts contracted by it in and about the management of the property. *Judicial repudiation of obligations is not to be sanctioned under any conditions.* One of the chief duties of courts of justice is to compel delinquent debtors to pay their debts. It could do this with poor grace indeed if it neglected to pay its own debts when it had the means to do so. It is true that the errors and mistakes of courts, though they may ruin a citizen, are placed in the category of injuries produced by the law, and for which the law furnishes no redress. But here the court has committed no error or mistake, and has it in its power to protect its contracts and its credit, and do justice to the citizens who trusted it. *While a court cannot be adjudged a bankrupt, and no proceedings can be taken against it to enforce payment of its obligations, these very facts make it all the more important that it should scrupulously observe its obligations to the citizen.* A court that would fail to

do this would speedily and justly forfeit the respect and confidence of the public. * * *" (Emphasis supplied)

The usual insolvency rule that where claims of the same rank exceed the fund for distribution no interest may be allowed on such claims, is pertinent here only to the extent that it would prevent interest from accruing on the operating claims and on the unpaid interest on the certificates. The interest on the certificates was expressly accorded equal rank with the principal thereof by the orders of the receivership court authorizing issuance and being due as a matter of right, i.e., having been contracted for by the receiver under express orders of the receivership court, disallowance of such interest and the preference granted to the operating expense creditors constituted a serious abuse of the court's duty to honor its own obligations. Furthermore, we submit, equity courts do not have discretion in the allowance of interest where interest is recoverable as a matter of right under the express order of court creating the indebtedness.

"Whether or not claims arising out of dealings with the receiver will bear interest is determined in accordance with the order of the court out of which the claim arises": *Tardy's, Smith on Receivers* (2d ed.) vol. II, sec. 598.

It is obvious that the accrued interest on the receiver's certificates was just as much a cost of operation of the railroad as, for example, the claim of The American National Red Cross for rentals on a line leased to the receiver. "Interest bears the same relation to money as rent does to land * * * Rent is compensation for the use of land or property, while interest is a sum paid for the use of money": *47 C. J. S.* sec 1 (p. 11).

The receiver had for many years the use of funds belonging to the certificate holders. Certainly if the receivership court is justified in allowing compensation for the use by the receiver of a line or railroad belonging to a third party it is obligated to pay interest on the funds which its receiver borrowed and used in connection with the operation of the estate.

We submit that the action of the courts below in repudiating the self-incurred obligations of the receivership court is a gross abuse of judicial power and flagrant violation of the established public policy that courts shall deal fairly and equitably with their own creditors. The keystone of administration by courts of equity of estates of insolvent debtors is the equitable maxim that "equality is equity". To approve the action of the courts below in this case, in discriminating among the debts of their own receiver, would bring into serious question the integrity of the judicial administration of insolvent estates.

For the reasons hereinabove stated, we submit that this application should be granted, the orders of the courts below reversed and such courts be directed to modify their orders in accordance with the principles stated in *Union Trust Company of New York v. Illinois Midland Railway Company, supra.*

Respectfully submitted,

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